Supreme Court, U. S.
FILED
MAR 24 1978
MICHAEL RODAK, JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1977

No. 77-1354

RALPH and ROSEMARIE FURRER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PRESTON C. HIEFIELD, JR.
WILLIAMS, STARK, HIEFIELD,
NORVILLE & GRIFFIN, P.C.
Attorneys at Law
775 Boise Cascade Building
Portland, Oregon 97201

Counsel for Petitioners

INDEX

AUTHORITIES CITED

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1977

No.

RALPH and ROSEMARIE FURRER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

Ralph and Rosemarie Furrer petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit entered December 30, 1977.

OPINIONS BELOW

The Opinion of the Court of Appeals (App. A) is reported at 566 F.2d 1115 (9th Cir. 1977). The Opinion of the Tax Court (App. B) is reported as 35 T.C.M. 1525 (1976).

JURISDICTION

The Judgment of the Court of Appeals was entered in December 30, 1977. This Petition for Certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether a judgment award recovered by Petitioner for an insurance company's breach of contract is taxable as ordinary income or capital gain.

STATUTES INVOLVED

26 USCA Section 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation

property used in his trade or business;

(3) a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by--

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in

the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

26 USCA Section 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

* * *

(3) Long-term capital gain. -- The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months if, and to the extent, such gain is taken into account in computing gross income.

STATEMENT OF THE CASE

This is a petition for a redetermination of the income tax liability of the Petitioners pursuant to a deficiency assessed by the Commissioner of Internal Revenue for the calendar year 1970.

On May 1, 1959, Petitioner entered into an Agreement with Industrial Hospital Association (IHA) whereby Petitioner became a special agent. The executed Agreement, in content highly unusual and unique, granted the Petitioner the right to develop, in any

area in which IHA was licensed to do business, as an exclusive independent contractor and not as an employee of the company, individual insurance business for IHA.

As special agent for IHA, Petitioner had the exclusive right to recruit agents to sell IHA's policies. He was authorized to negotiate sales agency agreements between the recruited agents and IHA. In addition, Petitioner developed new types of policies for IHA. He brought to IHA his concept of a dollar deductible health and accident insurance policy with an 80% co-insurance provision on a nonscheduled basis.

The Agreement provided that Petitioner would be compensated solely on a commission basis, with commissions computed as a percentage of the gross premiums paid on all individual policies. While Petitioner was associated with the IHA

companies, they provided him with office space and secretarial help. He was obliged, however, under the Agreement to bear all other expenses he incurred in his work, such as travel and telephone expenses.

The May 1, 1959, Agreement provided that it would remain in effect for one year, at the end of which time it was to be renewed automatically from year to year. Both parties had the right to terminate at the end of each renewal period by giving sixty days advance written notice. IHA, however, was prohibited from terminating the contract during any year in which net premiums (gross premiums less sales commissions) exceeded $500,000.00 and the pure claims loss is 60% or less on the net dues (gross dues less commissions paid).

During the period May, 1959, through February, 1966, Petitioner built up substantial goodwill, files and records co taining the agency agreements between IHA

and the individual agents he recruited, renewal agreements and correspondences concerning claim disputes. Petitioner also prepared a variety of sales literature and brochures pertaining to the individual policies offered, for which he received no reimbursement.

By February, 1965, Petitioner had created an agency sales force of over 800 agents, generating premiums received from the sale of individual policies in 1965 in excess of $900,000.00 per year, thereby invoking the foregoing prohibition of termination provision of the May 1, 1959, Agreement.

In February, 1966, IHA notified Petitioner that it was terminating the special agency Agreement as of May 1, 1966. During the year May 1, 1965, through April 30, 1966, however, the net premiums received on policies sold by the taxpayer's agents were sufficiently great and the percentage

of claims to premiums was sufficiently low as to bar such termination by IHA with respect to its IHA Oregon operations.

In subsequent declaratory judgment and breach of contract actions, the Multnomah County Circuit Court, with the Oregon Supreme Court affirming, granted Petitioner damages of $213,011.48. In computing the amount of damages, the Trial Court computed the present value of the commissions lost because of IHA's unlawful termination and subtracted from this amount: (1) the present value of the expenses necessary to perform the contract, (2) the present value of Petitioner's earnings subsequent to the termination of the 1959 Agreement, and (3) certain payments already made to Petitioner by IHA.

During the ensuing trial on the damages claim, the only evidence Petitioner presented relative to his damages pertained to his loss of commission income. However,

it is noted by Petitioners' attorney that one way to calculate a loss of a property right is by showing evidence of lost income.

On his 1970 Federal Income Tax Return, Petitioner reported the $213,011.48 as capital gain income and allocated the deduction for attorneys' fees and court costs between the award and interest therein. In November, 1974, the Commissioner asserted a deficiency against the taxpayer as to his 1970 income tax in the amount of $38,530.74. The large part of that deficiency was attributable to the Commissioner's determination that the award taxpayer received from IHA was taxable as ordinary income.

The United States Tax Court held that the judgment award was taxable as ordinary income. It reasoned that the characterization of a damage judgment for tax purposes should hinge upon the nature of rights being protected and injuries being

redressed. The Court took the view that the injury redressed here was the loss of commission income payable under the Agreement and concluded that taxpayer's damage recovery should be taxed as ordinary income. The United States Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court.

Petitioner seeks review, and reversal.

REASONS FOR GRANTING THE WRIT

This case involves a question which has constantly been litigated in American courts with inconsistent results, for the various Circuits have no uniform approach in determining the federal income tax treatment to be accorded to contract termination payments. In this area of contract rights, termination by sale, transfer or cancellation raises the following questions: should the taxpayer's gain in the sale or surrender be

characterized as ordinary income on the ground that the sales price or termination payment received is a substitute for the future ordinary income that would have been earned under the contract? Or should the gain be characterized as capital gain on the ground that contracts are like other capital assets--property rights that have value in the goodwill which attaches to them or because of their ability to produce, or contribute to the production of, future ordinary income? A court will look to see whether the asset "property" is a "capital asset" under Section 1221, whether the amount received represents a substitute for future ordinary income, and whether the transaction constitutes a "sale or exchange" to answer these questions.

The cases can nevertheless be divided into three categories: first, those decisions in which the disposition of a contract right is treated simply as an

anticipation of future income, under a standard Hort-Lake analysis; second, at the opposite pole, those which openly or impliedly reject the Hort-Lake approach and instead regard the termination of a contract right as a sale of property qualifying for capital gain; and third, those largely in the Second Circuit, which are decided under a rule of "substantiality" based upon an assumed distinction between simple contract claims and possessory interests in the nature of a lease. The cases in each category, to repeat, uniformly apply a concept of qualifying property, but with differing results.

The trend of the recent decisions in the Second Circuit is to analyze the rights disposed of and, where appropriate, to allocate the receipt between ordinary income and capital gain. The leading case in this area is Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962). Following a

"bundle of contract rights" approach, the Court held that a portion of the rights transferred as in the nature of goodwill and the allocable part of the total purchase price attributable thereto constituted capital gain, and that a portion of the rights was the right to receive a percentage of the profits, constituting ordinary income. In Commissioner v. The Pittston Co., 252 F.2d 344 (2d Cir. 1958), the same Circuit had previously determined that the cancellation of taxpayer's exclusive right to purchase certain coal did not constitute a "sale or exchange" within the meaning of the Section so as to entitle taxpayer to treat the amount received as capital gain. Yet in another Second Circuit case, Commissioner v. McCue Bros. & Drummond, 210 F.2d 752 (2d Cir. 1954), the Court found a payment received by a taxpayer lessee from a landlord on the sale of his leasehold interest subject to capital gain treatment,

finding the leasehold interest to be a property right.

In Maryland Coal & Coke v. McGinnes, 225 F.Supp. 854 (E.D. Pa., 1964), affirmed per curiam, 350 F.2d 293 (3d Cir. 1965), the Court, citing Second Circuit decisions, held that a taxpayer realized ordinary income on relinquishment of an exclusive contract to sell the entire output of a certain mine and receive commissions on such sales. However, in Commissioner v. Goff, 212 F.2d 875 (3d Cir. 1954), cert. denied, 348 U.S. 939 (1953), the Court had held that where taxpayers, who exchanged their interest in an exclusive Buy-Sell Agreement for stock in manufacturing corporation, the transaction constituted a sale or exchange of capital assets, within the meaning of the statute.

The Fifth Circuit, in Nelson Weaver Realty Corp. v. Commissioner, 307 F.2d 897 (5th Cir. 1962) held that the

taxpayer realized capital gain on the sale of its contractual rights to act as mortgage servicing agent for a life insurance company.

This is seemingly contrary to United States v. Eidson, 310 F.2d 111 (5th Cir. 1962) where the same Court held that a taxpayer realized ordinary income on the sale of its contractual rights to act as general agent for a life insurance company. In Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963) they adopted the Ferrer position and allocated a taxpayer's gain on the sale of a mortgage servicing business between capital gain and ordinary income. The portion of the gain attributable to goodwill, consisting principally of relationships with mortgagors and investors, was characterized as capital gain. The portion of the gain attributable to the mortgage servicing contracts was treated as ordinary income.

In Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10th Cir. 1962), the Tenth Circuit held that the taxpayer realized ordinary income on the sale of an exclusive license to use and sublease a patented process. In United States v. Dresser, 324 F.2d 56 (5th Cir. 1963), the Fifth Circuit held that the taxpayer realized capital gain on the sale of its exclusive license to use a patented process.

In Jones v. Corbyn, 186 F.2d 450 (10th Cir.1950), the Tenth Circuit held that the lump sum payment which the plaintiffs had received from a life time general insurance agency contract had been properly treated for tax purposes as a long term capital gain. In Elliott v. United States, 431 F.2d 1149 (10th Cir. 1970), a lump sum payment received for cancellation of a general insurance contract was characterized as ordinary income, the Court now viewing

the payment as a substitute for the ordinary income that would have been earned if the contract had not been cancelled.

Petitioner is aware that this Court has readily denied review in these cases. Commissioner v. The Pittston Co., 252 F.2d. 344 (2d Cir. 1958), cert. denied, 357 U.S. 919 (1958); Commissioner v. Goff, 210 F.2d 390 (5th Cir. 1954), cert. denied, 348 U.S. 829 (1954); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), cert. denied, 345 U.S. 939 (1953). However, a forthright answer to this question, important for the consistent administration of the capital gain tax, would provide judicial guidance by formulating a uniform approach.

CONCLUSION

For the foregoing reasons,

Petitioners respectfully request a Writ of Certiorari be granted.

Respectfully submitted,

WILLIAMS, STARK, HIEFIELD,
NORVILLE & GRIFFIN, P.C.

ORIGINAL SIGNED
PRESTON C. HIEFIELD JR.

By______________________
Preston C. Hiefield, Jr.
Attorney for Petitioner

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RALPH FURRER and ROSEMARIE FURRER, Appellants,	)	NO. 77-1588
vs.	)	OPINION
COMMISSIONER OF INTERNAL REVENUE, Appellee.	)	

December 30, 1977
[566 F.2d 1115(1977)]

Before: HUFSTEDLER, SNEED and KENNEDY, Circuit Judges.

PER CURIAM:

In this case we review the finding of the Tax Court that the damages taxpayer received for breach of his agency contract with an insurance company are taxable as ordinary income and not as capital gain. We affirm.

Ralph Furrer was a special agent for Industrial Hospital Association (IHA). His

contract with IHA gave him the exclusive right to recruit agents to sell IHA's policies; he also developed new types of policies for IHA. He was paid entirely on a commission basis, computed as a percentage of gross premiums paid on policies. The agreement provided for termination without notice, but IHA was prohibited from terminating during any year in which net premiums exceeded a certain amount. Furrer maintained files containing the agency agreements between the IHA and the individual agents he recruited, renewal agreements, and correspondence about claim disputes.

In violation of its agreement, IHA terminated Furrer's contract in 1968. In subsequent declaratory judgment and breach of contract actions, Oregon state courts found that the contract was wrongfully terminated and awarded Furrer damages of $2,13.000.

The characterization of the damages awarded depends upon both the nature of the claims

asserted amd the actual basis of the recovery. Thomson v. Commissioner, 406 F.2d 1006 (9th Cir. 1969); Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963). Thus, where there is a final judgment (in contrast to a settlement before judgment), the Court must examine both the claims set out in the pleadings and the proof at trial, and the characterization of the judgment by the awarding court. Whether the claims presented and the characterization of the award fit that aard into the categories of "capital gain" or "ordinary income" is a question of federal tax law. See Gray v. Commissioner, 561 F.2d 753 (9th Cir. 1977).

Appellant Furrer presents two arguments for characterizing the judgment as capital gain. The first argument assumes that the judgment was compensation solely for the loss of contract rights but asserts that those rights were in

viewed as giving appellant "substantial intangible property rights," including a nonterminable monopolistic right to "develop" sales territories in states where IHA was licensed to do buisness.

Appellant seeks to support his characterization of the judgment with the statement of the state trial judge who testified before the Tax Court that:

> the judgment which I awarded was intneded to reflect the value of his business efforts based upon his exclusive business rights under the agreement . . . and it was not intended to reflect payment for loss of prospective profits. I intended that an entire insurance business be valued . . . [capitalization of earnings] was just one method available to me to determine the value of the contract rights. It was no different than valuing any other asset.

Without deciding what weight may be accorded to a judge's post hoc testimony about a judgment he has rendered, we find this testimony

judgment he has rendered, we find this testimony affords appellant little comfort. Our holding does not rest upon the fact that the trial court arrived at the award through capitalization of earnings, a method equally applicable to determining the value of a capital asset. 1/ The pleadings, proof or judgment simply contain no evidence that the entire insurance business" amounted to anything more than the right to earn commissions.

If all contracts granting rights could be considered capital assets, without inquiry into

---

1/ In calculating damages, the state court subtracted the present value of appellant's future income, based upon his having secured ajob at another company at a salary of $18,000 per year. See Furrer v. International Health Assorance Co., 256 Or. 429, 474 P.2d 759, 767-68 (1970). Such mitigation is permisible only against an award for lost income and not against the loss of capital assets. If, on the other hand, the award was for the loss in part of commission income and in part of capital assets, some allocation would have been expected, since the offsetting income could be applied only against the former.

the nature of the rights granted, almost all ordinary income from salaries, wages or commissions could be transformed into capital gain. Furrer's right was the right to earn commission income. A long line of authorigy, some dealing with insurance agents, supports the conclusion that a lump sum payment for the termination of an agency relationship is ordinary income. This is true even though the contract be nonterminable and exclusive. Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962); Elliott v. United States, 431 F.2d 687 (10th Cir. 1970); Brown v. Commissioner 40 T.C. 861 (1963). The fact that others are excluded from the sources available to Furrer for earning income in no way changes the fact that his income derived from personal sevices and that what he lost through

termnation was the right to earn future income. And as we noted in Holt v. Commissioner, supra, at 691, "[t]he nature of the right to receive future income as ordinary income does not change into capital gain by the mere receipt of a lump sum in lieu of such future payments." Commissioner v. P.G. Lake Inc., 356 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1941). This attempted transubstantiation of income into capital must fail because the essential element - the capital asset, tangivle or intangible - is not present.

Appellant's second argument is that the termination of the agreement destroyed certain capital assets which he developed and owned, and that the judgment was, at least in part, in compensationfor those assets. But appellant presented no such argument in his pleadings or at trial in the state court. Only before the Tax Court did he argue that the termination resulted

in a loss of valuable goodwill and files of documents and information. In a detailed analysis, the Tax Court rejected this argument, concluding that "ther real value was in the right to receive future commissions." It found no evidence that the appellant had a right to ownership or exclusive use of the files or that those files contained anything not otherwise available to IHA. It concluded that whatever goodwill Furrer built up for IHA belonged to the latter, and whatever goodwill he built up for himself (such as personal contacts with the gents he recruited) he retained after the termination. See Vaaler v. United States, supra, at 1123. Appellant presents to us no evidence which undermines these largely factual conclusions.

In sum, appellant has failed to prove that the contract rights were themselves capital

assets or that the temination destroyed other capital assets which he had developed. The decisio of the Tax Court is therefore AFFIRMED.

APPENDIX B

T. C. Memo. 1976-331

UNITED STATES TAX COURT

RALPH FURRER and ROSEMARIE FURRER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1246-75. File October 28, 1976.

Gary M. Anderson and Preston C. Hiefield, Jr., for the petitioners.

Gary R. DeFrang, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FORRESTER, Judge: Respondent has determined a deficiency in petitioners' Federal income tax for the taxable year 1970 in the amount of $38,530.74. Concessions having been made, there are two issues for our decision: (1) Whether a judgment award recovered by petitioner for an insurance company's breach of a special agency contract is taxable as ordinary income or capital gain; and (2) Whether claimed deductions for the operating and depreciation expenses of a boat s.ould

be disallowed pursuant to section 274(d).[1]

FINDINGS OF FACT

Some of the facts have been stipuated and are so found.

Petitioners Ralph Furrer and Rosemarie Furrer, husband and wife, resided in Tigard, Oregon, at the time they filed the petition herein. Petitioners filed a joint Federal income tax return for 1970 with the office of the Interal Revenue Service at Ogden, Utah.

Petitioner Ralph Furrer (hereinafter petitioner) worked for the National Hospital Association (NHA) from 1935 to 1946. He returned to NHA in 1953 to develop individual policies and an agency force for NHA, which, at that time, was primarily marketing group insurance and limited individual policy coverage for group conversions. Petitioner was executive sales manager and a member of NHA's board of directors and, during the time he worked for that company, he developed new individual policies and an agency force of 400 to 500 agents.

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954.

On May 1, 1959, petitioner entered into a special agency agreement with Industrial Hospital Association, subsequently International Health Assurance Co. (both companies hereinafter referred to as IHA). The 1959 agreement was applied, by mutual consent, to IHA of Washington and IHA of Oregon which were wholly owned subsidiaries of IHA formed in 1960 and 1963, respectively. By December 1965, both IHA and IHA of Washington had merged into IHA of Oregon.

Under the 1959 agreement, IHA appointed petitioner as special agent and authorized him to solicit qualified agents as sales representatives for IHA's individual membership department and to negotiate agency agreements with such agents on behalf of IHA. Petitioner was also authorized to sell IHA's individual insurance. The agreement provided for petitioner's compensation on a commission basis with such commissions computed as a percentage of gross dues received by IHA on indivudal insurance policies. Petitioner agreed that such commissions would be his only compensation

from IHA and that all other expenses, such as travel and telephone expenses, would be borne by him. The agreement specifically provided that there was no intention between the parties to create an employer-employee relationship and that neither the agreement nor any earned commission under it could be assigned or transferred without the written approval of IHA. The agreement could be terminated by either party upon 60 days' notice. However, if IHA terminated the agreement, it was required to continue to pay the special agent such compensation as he would have been entitled had his services not been terminated for a period of three years on all dues received and accepted on individual policies sold by the special agent personally or agents whose agency agreements were negotiated by the special agent.

The 1959 agreement provided further that it could not be terminated if the gross annual dues received and accepted by IHA on individual policies sold by the special agent, or agents whose agreements were negotiated by him, exceeded a designated amount and if the claims on these

individual policies were below a specified percentage of the gross dues received by IHA.

During the years 1959 to 1965, inclusive, petitioner received compensation pursuant to the 1959 agreement, and he reported such compensation as ordinary income on his Federal income tax returns filed for those years.

By 1965, petitioner had developed an agency force of over 800 active agents generating gross dues from individual policies in 1965 in excess of $900,000. Petitioner likewise was instrumental in the development of the "dollar deductible policy" which the IHA companies (IHA, IHA of Oregon, and IHA of Washington) offered for sale. However, insurance policies which are offered for sale are filed with the Insurance Commisioner and are available for inspection and copying by all insurance companies. It is common for an insurance company to use concepts developed by other companies and, in fact, insurance concepts which petitioner felt he had developed while associated with the IHA companies were subsequently used by other insurance

companies.

Written agency agreements were executed between the IHA companies and the insurance agents who sold their insurance, and the IHA companies were designated as the principal in these agreements. However, several agents who worked under petitioner at IHA have become agents for petitioner's subsequent employer, Prudential Health Association (PHA).

Petitioner was instrumental in the development of these agency agreements. While associated with the IHA companies, petitioner maintained files on the agents that he supervised. These files contained the agency agreements, renewal agreements, and correspondence concerning claim disputes. Upon termination of petitioner's special agency agreement, the IHA companies took possession of these files.

While petitioner was associated with the IHA companies, they provided him office space and secretarial help at no charge. During the period from 1959 to 1965, the IHA companies incurred

advertising expenses of $101,600. In connection with his activities as a representative of the IHA companies, petitioner incurred expenses of approximately $60,000 for travel and other items for which he received no reimbursement from the IHA companies.

In February 1966, IHA of Oregon notified petitioner that it was terminating the 1959 agreement as of May 1, 1966. On May 4, 1966, petitioner filed a complaint for a declaratory judgment in the Circuit Court of the State of Oregon for Multnomah County. The case was tried without a jury, and by a letter dated October 17, 1967, the court notified the parties of its opinion. This letter opinion held that IHA of Oregon (known as International Health Insurance Co. at the time of trial) had wrongfully terminated the 1959 agreement, and the court awarded petitioner $150,000 as compensation "for his services." This letter opinion was later modified by eliminating reference to the $150,000 award.

On December 20, 1967, petitioner filed a

supplemental complaint in the state court proceeding seeking damages for breach of contract. At the conclusion of the damages trial, the court entered a decision for petitioner in the amount of $213,011.48. In computing the amount of damages, the trial court computed the present value of the commissions lost because of IHA's unlawful termination and subtracted from this amount, (1) the present value of the expenses necessary to perform the contract, (2) the present value of petitioner's earnings subsequent to the termination of the 1959 agreement, and (3) certain payments already made to petitioner by IHA. The trial court decision was affirmed on appeal in 1970 by the Supreme Court of Oregon in an opinion reported at 256 Ore. 429 and 474 P. 2d 759.

The pleadings in the above-described state court proceedings did not assert claims for the value of the records that petitioner maintained or for the goodwill and agency force that he developed during his association with IHA.

As a result of the circuit court's

decision, as affirmed by the Oregon Supreme Court, petitioner, in 1970, received $213,011.48 as damages for breach of contract and $24,307.29 as interest on the judgment. He incurred expenses of $65,963.54 for attorneys' fees and court costs.

On his 1970 return, petitioner reported the $213,011.48 as capital gain income and allocated the deduction for attorneys' fees and court costs between the award and the interest. On a schedule attached as part of petitioner's return, he reported the interest on the award, less the allocable portion of attorneys' fees and court costs, as ordinary income, but, inadvertently, this amount was not carried forward from the schedule and included as a part of petitioner's adjusted gross income. Petitioner has conceded such inadvertent error. In his statutory notice, respondent determined the amount received as damages and the interest thereon to be ordinary income and allowed the full amount of the attorneys' fees and court costs as a deduction from ordinary income.

The parties have stipulated that

petitioner should be allowed a deduction for attorneys' fees and court costs totaling $65,963.54 for the taxable year 1970 regardless of the characterization of the breach of contract award. However, if the award is characterized as capital gain income, then by stipulation, $58,700 of the attorneys' fees and court costs should be applied as a deduction in the computation of net long-term capital gain income and the remainder of such fees and costs should be applied as a reduction in computing net interest income.

During 1970, petitioner incurred the following expenses in connection with a boat that he owned:

Repairs	$ 857.97
Moorage	452.73
Gasoline, supplies, etc.	2,213.68
Insurance	319.00
Depreciation	919.27
Total:	$4,762.65

In his petition filed herein, petitioner claims 75 percent of these expenses ($3,571.99) as a business expense deduction.[2]

[2] On his 1970 income tax return, petitioner only claimed $2,647.71 (75 percent of $3,530.27) as a deduction for boat expenses. In his statutory notice, respondent disallowed such deduction. However, the petition herein claims an additional deduction of $924.28 for boat operating and depreciation expenses. Although the stipulation of facts states that the boat expenses are increased because certain expenses which are now listed as boat expenses were included in other expense categories on the return, respondent has not asked that the amount of any expenses, which he has previously allowed, be decreased in order to offset the increase in the claimed deduction for boat expenses.

Petitioner kept a boat guest register for the period July 22, 1970 to September 20, 1970. The register entries included the names of the passengers and, in a few cases, their employer and business address. Only one entry included petitioner's business relationship to the passenger. No records were kept of those occasions on which the boat was used for personal purposes.

Petitioner has conceded that claimed deductions of $3,086.53 for rental expenses and $2,429.98 for travel and entertainment expenses were properly disallowed by the Commissioner.

OPINION

The first issue for our consideration is the treatment of an amount totaling $213,011.98, which was awarded petitioner as damages for IHA's breach of contract. Petitioner argues frist that

the 1959 agreement was highly unique and that his collective rights thereunder constituted intangible property rights which were capital assets as defined under section 1221.[3]

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer

[3]SEC. 1221. CAPITAL ASSET DEFINED.

primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by--

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a axpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in

He contends that these intangible property rights were transferred to IHA in exchange for the damages award so that his gain is long-term capital gain within the meaning of section 1222(3).[4] Respondent argues that the loss of petitioner's right to receive commission income under the agreement was the only asserted claim in the state court proceedings and the only basis for which damages were awarded by that court. Respondent's position is that such a right is not a capital asset under section 1221 and, accordingly, the amounts received by petitioner constitute ordinary income.

The nature of the underlying claim and

---

the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

[4]SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

* * *

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross gross income.

the actual basis of recovery govern the characterization of amounts received in a judgment settlement as either ordinary or capital gain income. Thomson v. Commissioner, 406 F. 2d 1006 (9th Cir. 1969); Spangler v. Commissioner, 323 F. 2d 913 (9th Cir. 1963); State Fish Corp., 48 T.C. 465 (1967), and cases cited therein.

In the instant case, the complaints filed in petitioner's declaratory judgment suit and the subsequent damages trial assert claims based solely on the petitioner's right to recieve commission income under the 1959 agreement. Although petitioner argues otherwise, these complaints simply do not assert claims for the value of any rights which petitioner may have possessed in the goodwill, files and records or the agency force which he created while associated with IHA.

It is true that the Oregon Supreme Court took a broader view of the evaluation problem than that delineated by the pleadings. However, even if the damages awarded in the state court proceedings were intended to compensate petitioner for all the

property transferred, if any, it is obvious that the real value was in the right to receive future commissions. Joseph W. Brown, 40 T.C. 861 (1963).

The damages award did not represent the value of any goodwill, agency force, or records that petitioner transferred to IHA. Petitioner did not transfer any goodwill to IHA. Petitioner introduced no evidence indicating that he entered into a covenant not to compete with IHA. Apparently, he was perfectly free to contact the agents that he had obtained for IHA and to enlist them as agents for his new employer, PHA, as soon as his contract with IHA was terminated. In fact, the record shows that some IHA agents did become agents for PHA.

Accordingly, whatever goodwill petitioner built up for IHA while acting as its special agent resulted from his services as such agent and belonged to IHA, and whatever goodwill petitioner built up for himself as a special agent or an insurance agent while he served IHA under the special agency contract, he retained. Vaaler v. United States, 454 F. 2d 1120 (8th Cir. 1972);

1970); Harry M. Flower, 61 T.C. 140 (1973), affd. 505 F. 2d 1302 (5th Cir. 1974).[5] Likewise, the agents that petitioner obtained for IHA entered into agency agreements with IHA as principal, and these agents remained, as before, agents of IHA after petitioner left IHA. Vaaler v. United States, supra. Petitioner retained any personal goodwill that he may have built up through his contacts with these agents and the right to such personal goodwill was the only property right that he had in the agency force. Harry M. Flower, supra.

Furthermore, on the basis of the record in this case, we cannot conclude that petitioner had a right of ownership in the records that he left with IHA, or to the exclusive use of the information contained therein. Petitioner has not shown that these were personal records prepared for his own

[5] Roy W. Johnson, 53 T.C. 414 (1969), upon which petitioner relies, is distinguishable on the ground that the petitioners in Johnson entered into a covenant not to compete with the buyer pursuant to the contract for the sale of their general insurance agency business. In Johnson (supra at 425-426), we said, "the covenant not to compete was closely related to the sale of goodwill and therefore failed to have any independent significance apart from merely assuring the effective transfer of that goodwill."

legitimate purposes so that they belonged to him. Elliott v. United States, upra; Port. Inv. Co. v. Oregon Mut. Fire Ins. Co., 163 Ore. 1, 94 P. 2d 734 (1939); National Fire Ins. Co. v. Sullard, 97 App. Div. 233, 89 N.Y.S. 934 (2d Dept. 1904). Additionally, petitioner has not shown that the information contained in such records was unavailable to IHA from other sources.

In Commissioner v. Gilletee Motor Co., 364 U.S. 130, 134 (1960), Mr. Justice Harlan, writing for the Court, stated:

> While a capital asset is defined in section 117(a)(1) as "property held by the taxpayer," it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in stituations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. Burnet v. Harmel, 287 U.S. 103, 106.

Accordingly, the damages award in this case did not compensate petitioner for the loss of any property

which qualifies as a capital asset under section 1221. The damages award represented the value of petitioner's right to receive future commission income under the special agency contract, which right is not "property" for purposes of section 1221 and, therefore, not a "capital asset" as defined in section 1221. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Vaaler v. United States, supra, Commissioner v. Ferrer, 304 F. 2d 125 (2d Cir. 1962).[6]

---

[6] Petitioner relies upon Jones v. Corbyn, 186 F. 2d 450 (10th Cir. 1950), and Sammons v. Dunlap, an unreported case (N.D. Tex. 1952), 44 AFTR 924, 52-2 USTC par. 9481), as authority for treating his rights under the special agency contract as capital assets. these cases, however, are not persuasive authority in support of petitioner's position. In Elliott v. United States, 431 F. 2d 1149, 1154 (10th Cir. 1970), the court that decided Jones v. Corbyn noted that it no longer "stood * * * as the law of this circuit, unqualified or unmodified." Likewise, the decision in the Sammons case is unpersuasive because it is based on a very brief oral opinion without the citation of any case law or the citation of any case law or any authority whatever. Hyatt v. Commissioner, 325 F. 2d 715 (5th Cir. 1963), affg. a Memorandum Opinion of this Court. Further more, the Sammons decision is subject to the subsequent decision of the Court of Appeals for the Fifth Circuit in Roscoe v. Commissioner, 215 F. 2d 478 (5th Cir. 1954), which although not citing Sammons, strongly questions its rationale. See Maryland Coal & Coke Co. v. McGinnes, 225 F. Supp 854 (E.D. Pa. 1964), affd. 350 F. 2d 293 (3d Cir. 1965).

Petitioner next argues that even if the damages award represented only the value of his right to future commissions, which is not a capital asset under section 1121, he is, nevertheless, entitled to have the proceeds of such damages award treated as a capital gain by negative implication of section 1253[7] which specifies an instance in which the transfer of an exclusive business franchise

---

[7] SEC. 1253. TRANSFER OF FRANCHISES, TRADEMARKS, AND TRADE NAMES.

(a) General Rule.--A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

(b) Definitions.--For purposes of this section--

(1) Franchise.--The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

"shall not be treated as a sale or exchange capital asset." Petitioner reasons that since the breach of the special agency contract constituted the transfer of an exclusive business franchise[8] and since the section 1253 prohibition does not apply, he is therefore entitled to have the proceeds of such damages award treated as a capital gain. We disagree. We hold that in those transactions covered by section 1253, the taxpayer is entitled to capital-gains treatment only if the prohibition of section 1253 does not apply and the requirements of section 1221 and 1222 are met. Section 1222 defines long-term capital gain as the gain from the (1) sale or exchange (2) of a capital asset (3) held for more than six months. The first sentence of section 1221 defines a capital asset as "property held by the taxpayer" (emphasis supplied) subject to several exclusions, one of which is section 1221(1) excluding "property held by the taxpayer primarily for sale to customers in the ordinary course of his

[8]We assume, but do not decide, that the special agency contract is a franchise within the broad definition of section 1253(b)(1).

trade or business."

Having found no cases on point, we have looked to the legislative history of section 1253 which makes it clear that the section was intended to deal with the problems of (1) whether the transfer of a franchise is to be treated as a sale or license and (2) whether the transferors are selling franchises in the ordinary course of business.[9] By a careful study of its legislative history, we have concluded that, with respect to the transfer of franchises, section 1253 was intended to clarify the term "sale or exchange" as used in section 1222 and to eliminate the interpretive

[9]Present law.--The substantial growth of franchising throughout the United States in recent years has raised two significant problems: First, whether transfers of franchises are sales or licenses or, more particularly, whether the retention of powers, rights, or a continuing interest in the franchise agreement is significant enough to preclude a sale; and, second, whether franchisors are selling franchises in the ordinary course of business. [H. Rept. No. 91-413 (Part 1), 91st Cong., 1st Sess. (1969), 1969-3 C.B. 200, 300.]

It is difficult to resolve under present law whether the transfer of a franchise, trademark, or trade name is to be treated as a sale or as a license, and whether the transferors are selling franchises, trademarks, and trade names in the ordinary course of business. * * * [S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 423, 554.]

problems arising under section 1221(1), but we have found no evidence whatever that the section was intended to change the meaning of the term "property" for purposes of section 1221 or to eliminate the "capital asset" requirement as a prerequisite for capital-gains treatment.

The courts have quite uniformly held that the right to receive future income is not "property" as defined by section 1221 so that gain from its sale or exchange cannot be capital gain. Vaaler v. United States, supra, and the cases cited therein. We are not persuaded that section 1253 was intended to change this well-established legal principle absent a clear expression of congressional intent to do so, accord, United States v. Barnes, 222 U.S. 513, 520 (1912), and we are unable to find an expression of such intent in this instance. Accordingly, we hold that petitioner is not entitled to treat his gain from the damages award as capital gain because it is not gain from the sale or exchange of a capital asset and Congress, by enactment of section 1253, has neither changed the

general definition of a capital asset nor has it eliminated the "capital asset" requirement of section 1222 with respect to the transfer of exclusive business franchises.

We must next consider whether respondent has properly disallowed claimed deductions for the operating and depreciation expenses of a boat pursuant to section 274(d).[10] Petitioner's boat is a facility used in connection with entertainment, amusement, or recreation, and expenses with respect to it are disallowed unless the petitioner establishes that the facility is (1) used primarily

[10] SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

* * *

(d) Substantiation Required.--No deduction shall be allowed--

* * *

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity * * *

* * *

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item and, (D) the business relationship to the taxpayer of person entertained, using the facility, or receiving the gift. * * *

for the furtherance of petitioner's trade or business and (2) that the expense is directly related to the conduct of such trade or business. Sec. 274(a)

The Income Tax Regulations, promulgated pursuant to secton 274(h), amplify and clarify the requirements of section 274(d). These regulations have been held to be generally in accordance with the statute. William F. Sanford, 50 T.C. 823 (1968), affd. per curiam 412 F. 2d 201 (2d Cir. 1969). Section 1.274-5(c)(6)(iii), Income Tax Regs., requires the taxpayer to maintain records of each use of the facility containing such information as tends to establish its primary use. For each business use of the facility, such records should contain the amount, time, place, and business purpose of the entertainment, and the business relationship to the taxpayer of the persons entertained. For each personal use of the facility, such records should contain an appropriate description of the personal use including cost, date, number of persons entertained, the nature of

the entertainment and, if applicable, information such as mileage or its equivalent. Moreover, the regulations state:

> If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

Sec. 1.274-5(c)(6)(iii). Petitioner has failed to maintain adequate records concerning his boat, a facility likely to serve personal purposes, because he has failed to make a record of each use of the boat. Further more, petitioner has not overcome the presumption of primary personal use as set forth in section 1.274-5(c)(6)(iii), Income Tax Regs., because he has failed to substantiate--either by adequate records or by sufficient evidence corroborating his own statement--the business purpose and the business relationship to petitioner of the persons entertained for more than half of the days on which the boat was used.[11]

[11]Petitioner's self-serving testimony as to the business purpose of such entertainment is uncorroborated except for the one occasion where Ray Brunkow, who testified in the instant case, was entertained. The business purpose of the boat usage is not evident from the circumstance of the entertainment. Sec. 1.274-5(c)(2)(ii)(b), Income

Since petitioner has not established that more than 50 percent of the total calendar days of boat usage were days of business use, we hold that petitioner has not established that the boat was used primarily for furtherance of his trade or busines in that taxable year 1970. John L. Ashby, 50 T.C. 409 (1968); Sec. 1.274-2(e)(4)(iii), Income Tax Regs.

Decision will be entered for the respondent.

CERTIFICATE OF SERVICE

I hereby certify that I served the foregoing Petition for a Writ of Certiorari to the Court of Appeals for the Ninth Circuit on the Counsel for Respondent by enclosing a copy thereof in an envelope, postage prepaid, addressed to:

Emory Langdon, Regional Counsel
Internal Revenue Service
810 Crown Plaza
1500 S.W. First Avenue
Portland, Oregon 97201

Gary DeFrang, Esq.
Internal Revenue Service
810 Crown Plaza
1500 S.W. First Avenue
Portland, Oregon 97201

Meade Whitaker, Chief Counsel
Internal Revenue Service
Washington, D.C. 20224

and depositing the same in the United States mails at Portland, Oregon, on March 22, 1978, and further certify that all parties required to be served have been served.

ORIGINAL SIGNED
PRESTON C. HIEFIELD JR.

Preston C. Hiefield, Jr.
Attorney for Petitioner